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Supreme Court of the United States

OCTOBER TERM, 1950

No. 152

S. KLEIN ON THE SQUARE, INC.,
Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT AND BRIEF IN SUPPORT THEREOF

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Supreme Court of the United States

OCTOBER TERM, 1950

No.

S. KLEIN ON THE SQUARE, INC.,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

To the Honorable The Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:

The petitioner herein prays that a writ of certiorari be issued to review the judgment of the United States Court of Appeals for the Second Circuit, entered April 4, 1951, affirming a decision of the Tax Court of the United States rendered on July 12, 1950, determining deficiencies in the petitioner's excess profits taxes of $40,707.81 for the period April 16, 1944 to September 30, 1944, and of $90,342.73 for the year ended September 30, 1945.

Jurisdiction

The jurisdiction of this Court is invoked under Section 1254(1) of Title 28, United States Code.

Statement of the Matter Involved

The controversy involves the proper determination of the petitioner's excess profits and income tax liabilities for the taxable period April 16, 1944 to September 30, 1944 and for the taxable year ending September 30, 1945.

The case involves two issues: whether the exchange through which the petitioner originally acquired its assets qualified under I. R. C. Section 112(b)(5), and whether the petitioner qualifies as an acquiring corporation within I. R. C. Section 740:

(a) An exchange qualifies under Section 112(b)(5) where property is transferred to a corporation and immediately after the exchange the transferors are in control of the corporation. The primary Section 112(b)(5) issue here is whether an exchange, notwithstanding the fact that it was motivated by bona fide and independent non-tax purposes, is automatically disqualified under Section 112(b)(5) because the transferors who were originally in control ultimately sell their stock to third parties, pursuant to a prior plan.

(b) Under I. R. C. Sections 740(a)(1)(D) and (h), an acquiring corporation is a corporation acquiring the business of a sole proprietor. The issue here is whether under these provisions, a corporation acquiring the business of a sole proprietor is disqualified because the business was transferred to the corporation by the sole proprietor's executors by his express testamentary direction rather than by the proprietor personally during his lifetime.

The petitioner is the corporate successor to the clothing and ready-to-wear business in New York City, operated by its founder, Samuel Klein, as the sole proprietor until his

death on November 15, 1942 (R. 31). The S. Klein On The Square store is one of the best known in New York City and enjoys a unique reputation for merchandising (R. 31).

In his Last Will and Testament, Samuel Klein expressed the intention that his business be incorporated and that its name and reputation be perpetuated, and accordingly he directed his executors to incorporate his business if he had not already done so (R. 90, 31). He further provided in his Will that the business could not be sold to anyone unless the transaction gained the consent of the adult beneficiaries under his Will (R. 31). However, this requirement became a stumbling block when the Executors and the Klein family disagreed on the terms of incorporation (188 F. 2d, at 128).

During this dispute, following Samuel Klein's death, pending disposition and termination of the estate, the Executors carried on the proprietorship, continuing to operate the store as "S. Klein" and "S. Klein On The Square" (R. 61). Ultimately, in 1943, the Executors were obliged to petition the Surrogate of New York County for authority to proceed without the family's consent, and this was granted in March, 1944 (R. 61, 188 F. 2d, at 128).

As a result of this authority, the Executors executed on April 5, 1944, a certificate of incorporation and on the following day filed it with the Secretary of the State of New York (188 F. 2d, at 128). On April 6, 1944, pursuant to the New York Surrogate's direction, the Executors contracted with the family on the terms of incorporation, whereby the family would ultimately acquire the stock (R. 62, 122). Parenthetically, on April 3, the members of the family had executed an *inter sese* financial agreement of their own to which neither the Executors nor the corporation were ever parties (R. 62, 167).

On April 15, 1944, the petitioner issued 100% of its stock to the Executors in exchange for the S. Klein On The

Square business (R. 63). Six months later, on October 10, 1944, the Executors sold the stock to a group consisting of members of the Klein family (R. 64, 188).

In computing its Federal excess profits tax liability for the taxable periods involved, the petitioner computed its credit based on the average income of its own business during the base period because it was an "acquiring corporation". The Commissioner, however, restricted the petitioner's excess profits credit to the bare invested capital method. In addition, for the taxable periods, involved, the petitioner adopted as its basis for depreciation on its assets the adjusted basis which these assets had in the hands of their transferor. This was because the corporation acquired these assets from the Executors in an exchange to which the provisions of Section 112(b)(5) were applicable. The Commissioner claimed Section 112(b)(5) to be inapplicable on the grounds that the assets took a new cost basis in the hands of the petitioner.

The Tax Court and the Circuit Court below upheld the Commissioner as to Section 112(b)(5), although admitting the testator's directions and intentions, on the grounds that a pre-existing plan in itself disqualified a transaction under Section 112(b)(5). The Tax Court further held that even though concededly the corporation acquired and continued the identical S. Klein business, the bare existence of the Executors through whose custody the business passed to the corporation prevented the corporation from ever being an "acquiring corporation". The Circuit Court below, having felt the Section 112(b)(5) issue determinant, did not pass on the latter issue.

Questions Presented

1. Where a sole proprietorship is in operation throughout the excess profits tax base-period years and where the sole proprietor dies after the base period and, pursuant to his testamentary instructions, his executors incorporate the business, whether the business as incorporated is entitled to utilize the average income experience of the business during the base period in computing its excess profits credit.

2. Whether the benefits of Section 112(b)(5) are to be automatically denied to a taxpayer where, pursuant to a general plan of procedure worked out in the New York Surrogate's Court, the control of the corporation which first rested in the transferors is transferred to others subsequent to an exchange which would otherwise have qualified under Section 112(b)(5); particularly where the exchange served a *bona fide* and independent non-tax purpose.

Reasons Relied on for Granting the Writ

1. The decision of the United States Court of Appeals for the Second Circuit is in conflict with the decision of the Court of Appeals for the Third Circuit in *Commissioner of Internal Revenue* v. *American Bantam Car Co.*, 3rd Cir., 177 F. 2d 513, *aff'g* 11 T. C. 397 (1948), which upheld the validity of a Section 112(b)(5) exchange notwithstanding the fact that control eventually shifted to third parties by virtue of a general plan adopted prior to the exchange.

2. It is a novel and important question as to whether a business concededly in operation during the base period is to be denied the use of its own average income experience

merely because the sole proprietor's executor transferred the business to the corporation pursuant to the sole proprietor's directions, rather than the sole proprietor himself during his lifetime.

Conclusion and Prayer

For the reasons stated it is respectfully submitted that this petition to review the judgment of the United States Court of Appeals for the Second Circuit should be granted.

Respectfully submitted,

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BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

Opinion Below

The opinion of the Tax Court of the United States is reported at 14 T. C. 786 (R. 30). The opinion of the United States Court of Appeals for the Second Circuit is reported at 188 F. 2d 127 (R. 227).

Jurisdiction

The basis for this Court's jurisdiction is set forth in the Petition on page 1. A statement of the reasons relied upon by the petitioner for granting the writ are set forth on page 5.

Statement of the Case

We respectfully refer the Court to the Statement of the Matter Involved set forth in the Petition for Review which we believe states the case thoroughly but concisely in such fashion as to make its repetition here unnecessary.

Assignment of Errors

The petitioner assigns as error the following:

1. The holding of the Courts below that the exchange wherein the Executors, pursuant to the testamentary direc-

tion of their decedent, transferred the store property to the corporation in return for all its stock failed to qualify under I. R. C. Section 112(b)(5).

2. The failure of said courts to find that "S. Klein On The Square, Inc." acquired the "S. Klein On The Square" proprietorship within the meaning of I. R. C. Section 740(a)(1)(D).

SUMMARY OF ARGUMENT

I

The exchange whereby the Executors transferred the business to the corporation in return for 100% of the stock and securities of the corporation qualifies under Section 112(b)(5).

A. Where an exchange satisfies bona fide and independent non-tax purposes, it may qualify under Section 112(b)(5) even where by prior obligation the control of the corporation is ultimately transferred to third parties. The Third Circuit correctly holds so in *C. I. R. v. American Bantam Car Co.*, 3rd Cir., 177 F. 2d 513, aff'g 11 T. C. 397, in conflict with the Second Circuit below.

1. The conflict with *American Bantam Car*.

2. A "plan" is never automatically fatal. Section 112(b)(5) has often been held applicable notwithstanding the prior existence of a "plan".

II

The petitioner acquired the business owned by S. Klein within the meaning of I. R. C. Section 740 (a)-(1)(D) and is therefore not to be deprived of using its average income credit.

A. For the purposes of Section 740(a)(1)(D) the Executors stand in the place of their testator.

1. The policy underlying Section 740(a)(1)(D) is the selection of a norm for measuring excess profits.

2. Supplement A is a relief measure and is to be construed liberally in accordance with congressional intent.

B. The characterization of an executor under Section 740(a)(1)(D) should be determined by reference to the activity of his decedent.

1. An executor is the personal representative of his decedent.

2. Analogous precedent in the Internal Revenue Code requires the recognition of the continuity of the decedent and his business under Supplement A.

ARGUMENT

I

The exchange whereby the Executors transferred the business to the corporation in return for 100% of the stock and securities of the corporation qualifies under Section 112(b)(5).

On the fully stipulated facts, as well as both Court decisions below, it cannot be denied that the exchange in question meets the express qualifications of Section 112(b)(5). The Executors transferred property to a corporation in direct exchange for 100% of the stock and securities of the corporation which were duly issued to them (R. 63), and thereafter owned the stock for six months (R. 64). There is no question but that the statute is met.

However, the courts below concluded that because of a prior plan, Section 112(b)(5) was automatically inapplicable, without regard to any *bona fide* or independent non-tax purposes attendant upon the exchange. Yet, nowhere in the entire history of this case has it ever been asserted that the motivation of any action here was tax avoidance.

A. Where an exchange satisfies bona fide and independent non-tax purposes, it may qualify under Section 112(b)(5) even where by prior obligation the control of the corporation is ultimately transferred to third parties. The Third Circuit correctly holds so in *C. I. R.* v. *American Bantam Car Co.*, 3rd Cir., 177 F. 2d 513, *aff'g* 11 T. C. 397, in conflict with the Second Circuit below.

1. The conflict with *American Bantam Car.*

The defense that a *bona fide* transaction is merely an integrated part of a plan and therefore should be given a different legal consequence than that transaction ordinarily merits is a difficult one to judge. This is because the Com-

missioner of Internal Revenue is able to raise the defense contrary to proof and without reliance upon specific facts. If the Commissioner's "hunch" or "feeling" as to a particular case were to be determinant, there would be absolutely no predictability in tax administration. Because of this, there has grown up a series of principles governing the determination of when the effect of a single transaction should be submerged to the end result of a plan. There is emerging a distinct pattern of evaluation which the Third Circuit in the *American Bantam Car* case has recognized and reaffirmed in *ACF-Brill Motors Co.* v. *C. I. R.*, 3rd Cir., —— F. 2d —— (EPT CCH ¶66,014).

In the *American Bantam Car* case, wherein the Third Circuit adopts the Tax Court's reasoning *in toto*, an exchange is held to be within Section 112(b)(5), notwithstanding the existence of a prior plan of procedure and pre-existing obligation, in saying that,

> "In determining whether a series of steps are to be treated as a single indivisible transaction or should retain their separate entity, the courts use a variety of tests. Paul, *Selected Studies in Federal Taxation*, 2d Series, pp. 200-254. Among the factors considered are the intent of the parties, the time element, and the pragmatic test of ultimate result. An important test is that of mutual interdependence. *Were the steps so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series?*" [emphasis added] (11 T. C. 405).

It was further stated in the *American Bantam Car* case that,

> "It is true that all the steps may have been contemplated under the same general plan of May 1936; yet the contemplated arrangement for the sale of preferred stock to the public was entirely secondary and supplemental to the principal goal of the plan—to organize the new corporation and exchange its stock for the Austin assets" (11 T. C. 406).

With this is to be contrasted the flat mechanical application of the Second Circuit below,

> "Since [the Executors] were under an obligation to transfer the stock once they had received their consideration from the members of the family, or the subscribers to the April 3 agreement, they *cannot* be said to have been in 'control' of the new corporation . . . It is settled that the entire proceeding *must* be viewed as a single transaction." (188 F. 2d, at 129) [emphasis added].

Nowhere is any tax avoidance motivation hinted or in any way to the petitioner or the Executors or the S. Klein family. Nowhere in the entire record is it denied, nor could it be denied, that the incorporation of the petitioner failed to serve an independent, fruitful purpose. In fact, to the contrary, the Last Will and Testament of Samuel Klein, in so many words, expressed the intention that the business be carried on and his name be perpetuated, and actually directed the incorporation of the business (R. 90, 31).

Because the requirement that the adult beneficiaries had to consent to the disposition of the property became a stumbling block when the Executors and the family could not agree on the terms of the incorporation, the Executor had to petition the New York Surrogate to act free of the restrictions (188 F. 2d, at 128). It is notable that within one and a half months after being so authorized (R. 62) the Executors executed and filed a certificate of incorporation for S. Klein On The Square, Inc., which to this day perpetuates the name and business of S. Klein. Because of the Court's failure to consider the significance of any independent non-tax motivation, and because it mechanically denied the applicability of Section 112(b)(5) on the grounds of prior plan, the petitioner submits that the decision immediately below is in conflict with the *American Bantam Car* decision.

2. A "plan" is never automatically fatal. Section 112(b)(5) has often been held applicable notwithstanding the prior existence of a "plan".

Reasoning from such cases as *Bassick* v. *Commissioner*, 2d Cir., 85 F. 2d 8, *cert. den.* 299 U. S. 592, and *West Texas Refining & Development Co.* v. *Commissioner*, 10th Cir., 68 F. 2d 77, dealing with elaborate inter-corporate manipulations smacking of tax avoidance, the Court below dashes the incorporation here in question to the ground, stating that it was all part of a plan and that from the beginning the Executors were bound to convey the stock to someone else even though it was six months in the future. The cases cited by the Court are cases where the incorporation and exchange never would have been contemplated without a supplemental agreement to transfer stock.

The question of whether transferors had a pre-existing obligation to convey their stock is merely a reformulation of a query as to whether the transaction here at issue had sufficient independent non-tax purpose. An obvious illustration is the fact that many cases have openly involved plans where the transferors were under pre-existing obligation to transfer their stock and yet the exchanges were held to be within Section 112(b)(5).

The *American Bantam Car Co.* cites approvingly some of these cases. In *Samuel Insull, Jr.*, 32 B. T. A. 47 (modified on another point in 32 B. T. A. 567, 1070, remanded on this other point 7th Cir., 87 F. 2d 648), it was held that an exchange qualified under Section 112(b)(5) notwithstanding a "general plan of procedure which was determined and agreed upon" (32 B. T. A. at p. 51) prior to the organization of the corporation. In that case the prior agreement was reached informally in December, the properties transferred and all the stock issued on January 11th, and later the agreement was formalized in writing and enough stock transferred to destroy control if the "plan" theory of the Commissioner in that case had been adopted.

In *Federal Grain Corporation*, 18 B. T. A. 242, individuals transferred assets to a new corporation in return for all the stock. Pursuant to a written agreement executed prior to incorporation, the stock was transferred immediately to a voting trustee who had an option to purchase for five years. The original exchange was held to be within Section 112(b)(5).

Schmieg, Hungate & Kotzian, Inc., 27 B. T. A. 337, involved two partners S and K, who agreed with H to form a corporation, to transfer their property to the corporation, and to hire H. S and K were to have all the preferred stock, but only two-thirds of the common. H was to get one-third of the common. The corporation was subsequently organized in January, and at that time S and K transferred the property to the corporation. Pursuant to agreement H then resigned from his old job and came to work for the corporation. H, however, because of litigation pending against him, did not wish to take his stock then. Therefore, all the stock was issued to S and K, giving them the numerical quantum necessary for control which would have been missing had H taken his. In April, S and K conveyed one-third of the common stock to H. The Court held the exchange of S and K of the property in return for all the stock qualified under Section 112(b)(5).

II

The petitioner acquired the business owned by S. Klein within the meaning of I. R. C. Section 740(a)-(1)(D) and is therefore not to be deprived of using its average income credit.

A. For the purposes of Section 740(a)(1)(D) the Executors stand in the place of their testator.

The problem here involved is completely novel. In view of the reenactment of the Excess Profits Tax, the outcome

of this litigation is far-reaching. A sole proprietor operates a business continuously since 1900, and, while operating it, dies in 1942. In his Last Will and Testament, he directs his Executors to incorporate his business so as to perpetuate it and his name. The Executors, continuing the business while winding up the estate, form the corporation transferring to it the business properties. The corporation proceeds to continue the business in the decedent's exact manner, with his identical name, and location, for nearly a decade and is still doing so. In computing its excess profits tax credit, is the corporation entitled to utilize the average income experience of the business for the years 1936-1940?

The pivotal statute is Section 740(a)(1)(D) as extended in Section 740(h).

I. R. C. Section 740(a)(1)(D) reads in part as follows:

> "The term 'acquiring corporation' means—
>
> (1) a corporation which has acquired . . .
>
> (D) . . . the properties of a partnership in an exchange to which Section 112(b)(5) . . . is or was applicable."

I. R. C. Section 740(h) states:

> "For the purposes of Section 740(a)(1)(D) . . . a business owned by a sole proprietorship shall be considered a partnership."

On the premise that Section 112(b)(5) is applicable, petitioner believes it is entitled to the average income experience of its businss during the excess profits tax base period. It reaches this result from the face of the statute, the legislative history, and the available analogous case authority.

1. The policy underlying Section 740(a)(1)(D) is the selection of a norm for measuring excess profits.

Excess profits taxes represent a levy on that corporate income which is in excess of the level of income which Congress considered normal to the corporation. Generally speaking, there are two methods by which to determine what is the normal income of a corporation and what are the excess profits. One method is to establsh a percentage of the capital invested in the business as a normal return and to characterize the profit above that as excess profits. This is known as the invested capital method. The other method is to determine the average income of the corporation during a specified number of normal years, known as the base period. The amount of income above the average annual earnings of the base period is considered excess profits. This latter method is called the average earnings, or average income, method. A corporation normally may choose either method in computing its excess profits tax liability. A problem arose early in excess profits tax history, however, where businesses were operated as sole proprietorships or partnerships during the base period, only to be incorporated subsequent to the base period. Because these corporations were not in technical legal existence, as such, during the base period, they could not utilize the average earnings of their business during the base period as a norm in measuring their excess profits. To remedy this, Congress enacted Supplement A, which embraces Section 740 and its allied provisions. Even then, to correct inequities in measuring normal income, Congress felt obliged in 1941, one year later, to add Section 740(a)(1)(D).

The purpose then is to select a normal period of earnings for measuring excess profits where the taxpayer was technically not in legal existence during the base period. The narrow interpretation urged by the Court below would

deny its application in an ideal situation, where the same business was being carried on by the taxpayer and S. Klein. The interpretation of the Court below would defeat the use of the best available method of determining normal earnings, the base period experience of the same business.

2. Supplement A is a relief measure and is to be construed liberally in accordance with Congressional intent.

Paragraph 6, Report of the Ways and Means Committee (77th Cong., 1st Sess., H. Rept. 146), corresponding to Report of the Senate Finance Committee (77th Cong., 1st Sess. S. Rept. 75), provides that Section 740(a)(1)(D) is a relief provision and states as follows:

> ". . . Under present provisions a corporation formed as a result of the incorporation of a partnership or sole proprietorship may not use the earnings experienced by the latter in determining its excess profits credit based upon income. It is believed that this restriction operates inequitably with respect to such corporations."

As cited by respondent, himself, the House and Senate Committees, in the same reports, stated that

> "The bill extends this privilege to corporations growing out of partnerships or sole proprietorships in tax-free exchanges during this same period."

Finally, as stated in Regulation 112, Section 35.740-1, entitled "Purpose and Scope of Supplement A":

> "The purpose of Supplement A is in general to attribute to an acquiring corporation the existence of corporations, partnerships or businesses owned by sole proprietorships absorbed by it."

B. The characterization of an executor under Section 740(a)(1)(D) should be determined by reference to the activity of his decedent.

1. An executor is the personal representative of his decedent.

The established legal relationship existing between an executor and his testator is that of personal representation. It is settled that the authority of the executor to act is derived from the Last Will and Testament of the deceased. *Matter of Griffin*, 193 Misc. 419.

Under the laws of the State of New York, an executor winding up the business of a deceased proprietor stands in the shoes of the sole proprietor. The executor continues the personality of the deceased for the purposes of administration of the estate. *Flegenheimer* v. *Brogan*, 284 N. Y. 268. Treasury Reg. 112, Sec. 35.740-2(b) emphasizes this standing in place of the decedent concept by speaking of the approach of the statutory requirements as being:

> "to justify treating a corporation by which the assets of another corporation, a partnership, or a business owned by a sole proprietorship have been acquired, as *standing in the place of its predecessor.*" [emphasis added.]

It is quite clear, under the laws of New York, moreover, that where a testator directs the incorporation of his business and where the business and stock become the residuary trust fund, the executors may form the corporation and exercise control. *Matter of Doelger*, 254 App. Div. 178, *aff'd* 279 N. Y. 646. It is further settled that for tax purposes an executor may be in control of a corporation. *C. I. R.* v. *Brinckerhoff*, 2d Cir., 168 F. 2d 436.

2. Analogous precedent in the Internal Revenue Code requires the recognition of the continuity of the decedent and his business under Supplement A.

The question is whether for the purposes of Section 740(a)(1)(D) the relationship of the decedent and his business continues; whether the relationship of the decedent and his business is to be considered completely separate, as it is for some purposes under the Code, or is it to be one of continuance, as it is for other purposes under the Code. Petitioner contends that sound law requires the relationship to be a continuance.

The continuity of the decedent and his business activity is recognized each time throughout the Code where the decedent's economic activity is significant for a particular statutory purpose.

The most obvious application of this premise is that under Section 111 there is no recognition of gain or loss on the transfer of the decedent to his estate. Similarly, the Federal estate tax is an excise tax on the privilege of the transmission of property by the decedent to his devisees and distributees; *New York Trust Co.* v. *Eisner,* 256 U. S. 345, *Knowlton* v. *Moore,* 178 U. S. 41; yet while the tax is levied on the decedent for his exercise of the privilege of transmission, the transfer is actual made by his executor, thus emphasizing the identity of executor and decedent.

The concept of the executor standing in the business place of the decedent underlies the treatment of income in respect of decedents in Section 126, in that the character of income received by the executor is to be determined by reference to the decedent. As said in Reg. 111, Section 126-1, the estate is "placed in the same position with respect to the nature of this income as the position the decedent enjoyed". This concept similarly extends to Section 117

in that income which would have been capital gain to the decedent is capital gain to his executor.

Furthermore, Section 44(d), dealing with installment obligations demonstrates further the constant Internal Revenue Code technique of following the decedent's economic activity over into his executor. Under this section and Reg. 111, Section 29.44-5, where a decedent dies holding installment obligations, his executor may retain the obligations on a continued installment method. No gain on account of the transmission at death of such installment obligations need be reported.

In each place in the Code where the decedent's economic activity is significant for the purposes of particular treatment, his executor is considered as standing in his place.

CONCLUSION

Petitioner prays that a writ of certiorari issue to the United States Court of Appeals for the Second Circuit to review its judgment.

Respectfully submitted,

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APPENDIX

Statutes and Regulations

Internal Revenue Code:

"Section 112. Recognition of Gain or Loss.

• • •

(b) *Exchange solely in kind.*—

• • •

(5) *Transfer to corporation controlled by Transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange. Where the transferee assumes a liability of a transferor, or where the property of a transferor is transferred subject to a liability, then for the purpose only of determining whether the amount of stock or securities received by each of the transferors is in the proportion required by this paragraph, the amount of such liability (if under subsection (k) it is not to be considered as "other property or money") shall be considered as stock or securities received by such transferor.

• • •

(h) *Definition of Control.*—As used in this section the term 'control' means the ownership of stock possessing at least 80 per centum of the total combined voting power of

all classes of stock entitled to vote and at least 80 per centum of the total number of shares of all other classes of stock of the corporation."

• • •

U. S. Treasury Regulations 111:

Section 29.112(h)-1. *Definition of Control.*—Section 112(h) defines the term 'control' in reference to the phrase 'control of the corporation', as used in section 112(b)(5) and section 112(g)(1). It is provided specifically that this definition is limited to the meaning of 'control' as that term is used in section 112."

• • •

Internal Revenue Code:

Section 740. DEFINITIONS.

• • •

(a) *Acquiring corporation.*

• • •

(1) A corporation which has acquired—

• • •

(D) substantially all the properties of a partnership in an exchange to which section 112(b)(5), or so much of section 112(c) or (e) as refers to section 112(b)(5), or to which a corresponding provision of a prior revenue law, is or was applicable.

• • •

(h) *Sole proprietorship.* For the purposes of sections 740(a)(1)(D), 740(b)(5), and 742(g), a business owned by a sole proprietorship shall be considered a partnership.

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In the Supreme Court of the United States

OCTOBER TERM, 1951

No. 152

S. KLEIN ON THE SQUARE, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Court of Appeals (R. 227-231) is reported at 188 F. 2d 127. The opinion of the Tax Court (R. 31-40) is reported at 14 T. C. 786.

JURISDICTION

The judgment of the Court of Appeals was entered on April 4, 1951. (R. 231-232.) The petition for a writ of certiorari was filed on June 28, 1951. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Whether in the computation of the excess profits tax credit on the income method taxpayer is entitled to the base period experience of a decedent, S. Klein, who operated the business as sole proprietor during the base period years and until his death in 1942. The answer to this question, under Section 742, Internal Revenue Code, turns on (1) whether the taxpayer acquired its assets in an exchange to which Section 112(b)(5) was applicable as required by Section 740(a)(1)(D), and (2) if so, whether the decedent was a "component corporation" within the meaning of Section 740(b)(5).

STATUTE AND REGULATIONS INVOLVED

The pertinent parts of the statute and regulations involved are set forth in the Appendix, *infra*, pp. 11-19.

STATEMENT

The facts were stipulated (R. 60-196), and may be summarized as follows:

Taxpayer is the corporate successor to a clothing and ready-to-wear business at 14 Union Square, New York City, operated by its founder, Samuel Klein, as sole proprietor until his death on November 15, 1942. In his will he directed his executors to incorporate the store and perpetuate his name. The store was part of the residue of the estate, which went into a trust fund whose beneficiaries were Klein's three daughters, four sisters

and his three brothers. The will also contained a provision that the executors could not sell the property unless a majority of the adult income beneficiaries gave their approval in writing. This requirement became a stumbling block when the executors and Klein's family disagreed on the terms of incorporation. Accordingly, in 1943 the executors petitioned the Surrogate of New York County for authority to proceed without such approval, and to disregard the direction for incorporation of the business. The authority was granted on March 3, 1944. (R. 31-32, 61, 97-106.)

On April 3, 1944, Klein's son-in-law, Herbert D. Stone, representing the family, agreed with the members of the family he was representing to try to raise $1,000,000 to buy the stock in the anticipated corporation. An offer was made by the Stone group to buy all of the stock of a corporation to be organized by the executors. The Surrogate ordered that the business be sold in accordance with that offer. On April 5, 1944, Klein's executors executed a certificate of incorporation for the taxpayer and the following day (April 6) filed it with the Secretary of the State of New York. On the latter date the executors and Stone agreed on the proposal previously approved by the Surrogate's Court. By this the parties to the April 3 agreement, acting through Stone, were to pay $1,000,000 for the stock of the new corporation: $100,000 which had been paid at the time of the offer in the Surrogate's Court, $100,000 at the time

of the April 6 agreement, and $800,000 on or before April 11, 1944. The executors agreed to deliver to Stone 4,000 shares of Class A stock, endorsed in blank, immediately upon the closing of the transaction. (R. 32-33, 62, 122-185.) On April 15, the executors and taxpayer's directors in substance exchanged the store's assets for all the stock in the corporation, of which there were several classes. The record does not show whether or not the $800,000 was actually paid but the Tax Court stated that it "apparently" was (R. 34) and the Court of Appeals so assumed (R. 228-229). In any event, the executors voted the stock on April 15 to elect members of the Stone syndicate as the directors and officers of taxpayer. (R. 165-166, 210-211, 216.) The executors continued to hold the stock issued to them, but subsequently endorsed it in blank, until October 10, 1944, when new certificates were issued either to the persons or to the nominees of persons who were represented by Stone. (R. 33-34.)

In determining the deficiencies the Commissioner computed the excess profits net income for both periods involved (April 16, 1944, to September 30, 1944, and fiscal year ended September 30, 1945) on the invested capital method, explaining that the taxpayer did not qualify as an acquiring corporation within the meaning of Section 740 and, therefore, was not entitled to have its excess profits computed on the income method. (R. 34-35.) The Tax Court, in a reviewed decision from which no judge dissented, approved the Commissioner's de-

termination. (R. 31-40.) The Court of Appeals affirmed. (R. 231.)

ARGUMENT

1. Section 742 of the Internal Revenue Code (Appendix, *infra*, pp. 13-14) permits an "acquiring corporation" to use the base period income experience of its "component" corporations for the purpose of computing the excess profits tax credit on the income method under Section 713. Both courts below held that the transfer of the assets used in the business of the decedent by his executors to taxpayer—organized by them in return for all of the stock which, under a pre-existing contract and order of the Surrogate's Court, was required to be sold to certain of decedent's devisees and relatives—did not meet the control requirements of Code Section 112(b)(5) (Appendix, *infra*, p. 11). Under the provision of Section 740(a)(1)(D) (Appendix, *infra*, p. 12), upon which taxpayer relies, compliance with Section 112(b)(5) is required before taxpayer can be considered an "acquiring corporation."

This holding is unquestionably correct because the sole purpose of incorporating the taxpayer, as both courts below viewed the stipulated facts, was to give control of the S. Klein assets to the members of the Stone syndicate. The circumstance that the stock was temporarily in the physical custody of the executor-transferors does not satisfy the continuity of interest requirement which is the underlying assumption of both Section 740(a)(1)

(D) and Section 112(b)(5), as is made plain by the statutory language and the Regulations,[1] because, as we have emphasized, it cannot be disputed that the purpose of the transfer was not to perpetuate the executor's control but to effect a sale of the business, the antithesis of the situation contemplated by the statute. The holding that under these circumstances the transferors were not "immediately after the exchange * * * in control of the corporation" as required by Section 112(b)(5) is in accord with all of the decided cases. *Bassick* v. *Commissioner*, 85 F. 2d 8 (C.A. 2), certiorari denied, 299 U.S. 592; *West Texas Refining & D. Co.* v. *Commissioner*, 68 F. 2d 77 (C.A. 10); *Hazeltine Corp.* v. *Commissioner*, 89 F. 2d 513 (C.A. 3); *Halliburton* v. *Commissioner*, 78 F. 2d 265, 267 (C.A. 9). Cf. *Ahles Realty Corp.* v. *Commissioner*, 71 F. 2d 150 (C.A. 2), certiorari denied, 293 U. S. 611.

Taxpayer bases its petition for certiorari, on the

---

[1] Section 35.740-2(b), Treasury Regulations 112 (Appendix, *infra*, pp. 18-19), states that since Supplement A of the Code (Sections 740 and 742) applies only to cases where there is a sufficient continuity of interest to justify treating a corporation which has acquired the assets of a partnership or sole proprietorship as standing in the place of its predecessor, "such transactions must satisfy all the requirements of the regulations prescribed under section 112 * * *." And Section 29.112(b)(5)-1, Treasury Regulations 111 (Appendix, *infra*, pp. 15-16), interpreting Code Section 112(b)(5), states:

> The phrase "immediately after the exchange" * * * comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure.

Section 112(b)(5) issue, solely on the contention (Pet. 5) that the decision below is in conflict with *American Bantam Car Co.* v. *Commissioner,* 177 F. 2d 513 (C.A. 3). The contention is without foundation. In that case the transferors did not enter into a prior binding contract to transfer their stock in the transferee to third parties as was done here, but, on the contrary, entered into a highly contingent agreement to do so only after the transferors were in control of a new corporation. The opinion of the Tax Court (*American Bantam Car Co.* v. *Commissioner,* 11 T.C. 397, 406), which was affirmed *per curiam* by the Court of Appeals, itself distinguished the *Hazeltine* and *Bassick* cases cited, *supra,* on the grounds that in *American Bantam* "there was no written contract prior to the exchange" and "the underwriters received no absolute right to ownership of the common stock, but only when, as, and if, certain percentages of preferred stock were sold." The court further pointed out (p. 406): "How clearly contingent was the nature of their rights is illustrated by the fact that only one underwriter, Grant, met the terms of the agreement and became entitled to any shares."

Taxpayer attempts (Br. 10-14) to bring this case within the rationale of the *American Bantam* case by suggesting that the incorporation of the taxpayer would have proceeded independently of the contract with the Stone group. This argument is premised on a state of facts contrary to those

stipulated, as viewed by both courts below, and does not merit serious consideration.

2. In an alternative holding the Tax Court concluded (R. 38-40) that even if the transfer to taxpayer by the executors had met the requirements of Section 112(b)(5), taxpayer would nevertheless not have been entitled to the base period experience it sought to utilize, because the transfer had been made by the executors who had no such experience to transmit. In the statutory terminology the holding was that compliance with Section 112(b)(5) would have at best made the executors, and not the decedent, a component corporation of taxpayer under Section 740(a)(1)(D) and (b)(5). The Court of Appeals did not reach this issue but indicated (R. 230-231) that had the question been squarely before it it would have agreed with the Tax Court.

In this posture of the case, the alternative issue affords no basis for the issuance of the writ of certiorari, as urged by taxpayer, because there is no need to resolve that issue unless there should be a determination adverse to the Commissioner on the Section 112(b)(5) question.[2] In any event, there is no substance to taxpayer's argument on the merits of the issue, no reasonable support therefor being found in the language of Section 740. Cf. *E. T. Renfro Drug Co.* v. *Commissioner*, 183 F. 2d 846 (C. A. 5), certiorari denied, 340 U. S.

[2] Admittedly, the point is one of first impression (Pet. 5-6), and there is, of course, no question of a conflict.

930. Taxpayer rests its contention principally (Br. 14-16) on the unsupported assertion that the purpose of Supplement A was to grant all corporations the benefit of the income experience of any predecessor business. The argument thus advanced ignores the fact, clearly attested by the language of Supplement A, Appendix, *infra,* pp. 12-14, that a taxpayer who, as a matter of right, is entitled under the statute to utilize the base period experience of a predecessor must not only operate substantially the same business as the predecessor, but in addition, the ownership of the business must be essentially the same.

Taxpayer's contention that the Commissioner's position (Br. 17) "would defeat the use of the best available method of determining normal earnings" overlooks the controlling consideration that under the congressional policy as expressed in Supplement A the present owners of the business did not create the income experience of the base period and therefore should not be allowed to use it. It is plain that adoption of taxpayer's policy would result in the artificial and unrealistic standard of measuring its excessive profits by the experience of a stranger in operating that business.

Taxpayer's further contention (Br. 19-20) that there is "analogous precedent" under the Code for recognition of the continuity of the decedent and his estate proves too much because Supplement A, unlike the other provisions relied upon by taxpayer, provides no such identity, and in any

event, generally the Code treats decedents and their estates as separate taxpayers. Internal Revenue Code, Subchapter C—Supplement E; see, for example, *Estate of Putnam* v. *Commissioner*, 324 U. S. 393; *Helvering* v. *Enright*, 312 U. S. 636.

CONCLUSION

The decision below is correct. There is no conflict of decisions. The petition for a writ of certiorari should be denied.

Respectfully submitted,

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AUGUST, 1951.

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APPENDIX

Internal Revenue Code:

SEC. 112. RECOGNITION OF GAIN OR LOSS.

* * * * *

(b) *Exchanges Solely in Kind.*—

* * * * *

(5) *Transfer to Corporation Controlled by Transferor.*—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

* * *

* * * * *

(h) *Definition of Control.*—As used in this section the term "control" means the ownership of stock possessing at least 80 per centum of the total combined voting power of all classes of stock entitled to vote and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

* * * * *

(26 U.S.C. 1946 ed., Sec. 112.)

PART II—Rules in Connection With Certain Exchanges [As added by Sec. 201, Second Revenue Act of 1940, c. 757, 54 Stat. 974]

Supplement A—Excess Profits Credit Based on Income

SEC. 740. DEFINITIONS.

For the purposes of this Supplement—

(a) *Acquiring Corporation.*—The term "acquiring corporation" means—

(1) A corporation which has acquired—

* * * * *

(D) [Added by Sec. 8(a) of the Excess Profits Tax Amendments of 1941, c. 10, 55 Stat. 17.] Substantially all the properties of a partnership in an exchange to which section 112 (b) (5), or so much of section 112 (c) or (e) as refers to section 112 (b) (5), or to which a corresponding provision of a prior revenue law, is or was applicable.

* * * * *

(b) *Component Corporation.*—The term "component corporation" means—

* * * * *

(5) [Added by Sec. 8(b) of the Excess Profits Tax Amendments of 1941, *supra.*] In the case of a transaction specified in subsection (a) (1) (D), the partnership whose properties were acquired.

* * * * *

(g) [Amended by Sec. 228(a) of the Revenue Act of 1942, c. 619, 56 Stat 798] *Component Corporations of Component Corporations.*—If a corporation is a component corporation of an acquiring corporation, under

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subsection (b) or under this subsection, it shall (except for the purposes of section 742 (d) (1) and (2) and section 743 (a) (1), (2), and (3)) also be a component corporation of the corporation of which such acquiring corporation is a component corporation.

(h) [Added by Sec. 8(c) of the Excess Profits Tax Amendments of 1941, *supra*] *Sole Proprietorship.*—For the purposes of sections 740 (a) (1) (D), 740 (b) (5), and 742 (g), a business owned by a sole proprietorship shall be considered a partnership.

(26 U.S.C. 1946 ed., Sec. 740.)

SEC. 742 [as amended by Section 228 (c) of the Revenue Act of 1942, *supra*]. SUPPLEMENT A AVERAGE BASE PERIOD NET INCOME.

In the case of a taxpayer which is an acquiring corporation, its average base period net income (for the purpose of the credit computed under section 713) shall be the amount computed under section 713 or the amount of its Supplement A average base period net income, whichever is the greater. The Supplement A average base period net income shall be the amount computed without regard to subsection (h) of this section or computed under subsection (h) of this section, whichever is the greater. The Supplement A average base period net income shall be computed as follows:

* * * * *

(g) In the case of a partnership which is a component corporation by virtue of section 740 (b) (5), the computations required by this

Supplement shall be made, under rules and regulations prescribed by the Commissioner with the approval of the Secretary, as if such partnership had been a corporation. For the purpose of such computations, in making the adjustment for income taxes required by section 711 (b) (1) (A), the partnership so regarded as a corporation shall be considered as having distributed all its net income as a dividend.

* * * * *

(26 U. S. C. 1946 ed., Sec. 742.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

SEC. 29.112(a)-1. *Sales or Exchanges.*—The extent to which the amount of gain or loss, determined under section 111, from the sale or exchange of property is to be recognized is governed by the provisions of section 112. The general rule is that the entire amount of such gain or loss is to be recognized.

An exception to the general rule is made by section 112(b) (1) to (5), inclusive, in the case of certain specifically described exchanges of property * * * The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated.

* * * * *

The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Internal Revenue Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand. The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception.

To constitute an exchange within the meaning of section 112(b) (1) to (5), inclusive, the transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only.

* * * * *

SEC. 29.112 (b) (5)-1. *Transfer of Property to Corporation Controlled by Transferor.* —As used in section 112(b)(5), the phrase "one or more persons" includes individuals, trusts or estates, partnerships and corporations (see section 3797); and to be in "control" of the transferee corporation such person or persons must own immediately after

the transfer stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of such corporation. (See section 112(h).) The phrase "immediately after the exchange" does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure.

* * * * *

Example (3). B owns certain real estate which cost him $50,000 in 1920, but which has a fair market value of $200,000 in 1942. He transfers the property to the N Corporation in 1942 for 78 percent of each class of stock of the corporation, the remaining 22 percent of the stock of the corporation having been issued by the corporation in 1933 to other persons for cash. B realizes a taxable gain of $150,000 on this transaction. (See section 112(h).)

* * * * *

SEC. 29.112(h)-1. *Control of Corporation.* —Section 112(h) defines the term "control" in reference to the phrase "control of the corporation," as used in section 112(b)(5) and section 112(g)(1). It is provided specifically that this definition is limited to the meaning of the term "control" as that term is used in section 112.

Treasury Regulations 112, promulgated under the Internal Revenue Code:

SEC. 35.740-1. *Purpose and Scope of Supplement A.*—(a) The term "Supplement A," when used in these regulations, means sections 740 and 742 to 744. Supplement A provides rules governing the right to use the excess profits credit based on income and the method of computing such credit, in the case of certain "acquiring" corporations. An acquiring corporation is a domestic corporation which has absorbed one or more other domestic corporations, partnerships, or businesses owned by sole proprietorships in a transaction meeting the requirements set forth in section 740(a), which transaction is generally referred to in these regulations as a "Supplement A transaction." Each such absorbed corporation, partnership, or business owned by a sole proprietorship is designated a component corporation of the acquiring corporation. Furthermore, except for the purposes of section 742 (d) (1) and (2) and section 743(a) (1), (2), and (3), if an acquiring corporation is later absorbed by another acquiring corporation, all of the component corporations of the first acquiring corporation become component corporations of the second acquiring corporation. * * *

(b) The purpose of Supplement A is in general to attribute to an acquiring corporation the existence of corporations, partnerships, or businesses owned by sole proprietorships absorbed by it, together with the base period excess profits net income or deficit in excess

profits net income and the net capital changes of such predecessors, in order (1) that a corporation the corporate life of which in substance, though not in form, includes the base period may use the excess profits credit based on income and (2) that a corporation composed in whole or in part of component corporations may compute its excess profits credit in the light of the base period experience of the entire enterprise. * * *

SEC. 35.740-2. *Transactions Whereby a Corporation Becomes an Acquiring Corporation.*—(a) The types of transactions whereby a corporation can become an acquiring corporation are specifically described in section 740(a). In addition to statutory mergers and consolidations and the acquisition of property in a complete liquidation in which gain or loss is not recognized because of the provisions of section 112(b)(6) or the same section as contained in the Revenue Act of 1936 or 1938, only the following types of transactions are included:

* * * * *

(4) The acquisition of substantially all the properties of a partnership in an exchange to which section 112(b)(5), or so much of section 112(c) or (e) as refers to section 112(b)(5), or to which the corresponding provisions of a prior revenue law, is or was applicable. For the purposes of this paragraph a business owned by a sole proprietorship shall be considered a partnership.

(b) The types of transactions set forth in section 740(a), other than those set forth in

section 740(a)(1)(C), either are embraced within the definition of a reorganization contained in section 112(g)(1), are transfers to a controlled corporation within the meaning of section 112(b)(5) and related sections, or are complete liquidations within the meaning of section 112(b) (6). Since Supplement A applies only to cases where there is a sufficient continuity of interest to justify treating a corporation by which the assets of another corporation, a partnership, or a business owned by a sole proprietorship have been acquired, as standing in the place of its predecessor, such transactions must satisfy all the requirements of the regulations prescribed under section 112 with respect to such transactions in order that the transferee corporation may be treated as an acquiring corporation.

* * * * *

SEC. 35.740-4. *Partnerships and Sole Proprietorships Under Supplement A.*—A partnership (or a business owned by a sole proprietorship) can be a component corporation for the purposes of Supplement A, subject to the exceptions in section 740(g). However, a partnership (or a business owned by a sole proprietorship) cannot be an acquiring corporation and, therefore, section 740 (g) cannot operate to make any of its predecessors component corporations of its acquiring corporation.

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